Supreme Court, U.S.
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No. 91-42

In The Supreme Court of the United States October Term, 1991

UNITED STATES OF AMERICA,
Petitioner,

v.

THERESE A. BURKE, *et al.*,
Respondents.

BRIEF OF WOMEN EMPLOYED, 9TO5, NATIONAL ASSOCIATION OF WORKING WOMEN AND CHICAGO LAWYERS' COMMITTEE FOR CIVIL RIGHTS UNDER LAW, INC. AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF AMICI CURIAE

Women Employed is a membership association of 2,000 women at all employment levels. It conducts innovative research, education and advocacy programs designed to improve women's economic status. Since its founding in 1973, the organization has achieved national recognition for its efforts to increase employment opportunities for women by advocating improved equal opportunity policies and greater access to vocational education and job training systems, and by developing model programs to enable disadvantaged women to become economically self-sufficient.

9to5, National Association of Working Women, is a voluntary association with more than 15,000 members nationwide. It is the preeminent membership organization for the nation's 20 million office workers. Headquartered in Cleveland, Ohio, with offices on the east and west coasts, chapters in twenty-six states, and members in all states, it works toward the eradication of

discrimination based on sex, race, age, color, religion, disability, national origin, ancestry, or sexual preference.

The Chicago Lawyers' Committee for Civil Rights Under Law, Inc. ("Lawyers' Committee") was founded in 1969 by major Chicago law firms to involve private attorneys in the effort to assure the civil rights of all persons in the metropolitan area. Since its inception, the Lawyers' Committee has enlisted the *pro bono* legal services of many hundreds of attorneys in addressing the legal problems of members of minority groups, women, the disadvantaged, and the poor in employment, housing, education, the administration of justice, voting, and law enforcement.

Of particular concern to the amici and their members is the full recovery of compensation permitted by law for the victims of discrimination. Amici have devoted substantial energy and resources to the protection of remedies available to persons who have suffered discrimination. Those efforts have included litigation, legislative advocacy, and the filing of briefs as amicus curiae.

Amici believe the decision of the court of appeals is correct, and submit this brief to assist the Court in resolution of the case. [1]

INTRODUCTION AND SUMMARY OF ARGUMENT

Section 104(a)(2) of the Internal Revenue Code (the "Code"), 26 U.S.C. §104(a)(2), excludes from the definition of gross income "the amount of any damages received on account of personal injuries." Title VII of the Civil Rights Act of 1964, 42 U.S.C. §2000e, *et seq.* ("Title VII"), makes it unlawful to discriminate, in respect to employment, on the basis of race, sex or national origin. Application of §104(a)(2) to Title VII recoveries is, on its face, quite straightforward: The discrimination outlawed by Title VII invades a plaintiff's right to be free of such invidious discrimination and is a "personal" injury. Title VII is an antidiscrimination law, not a backpay provision; backpay is simply an enforcement tool under that statutory scheme. Thus,

[1] The parties' letters of consent, pursuant to Rule 37 of the Rules of this Court, have been filed with the Clerk.

any damages received on account of an injury under Title VII should be excluded by §104(a)(2).

To avoid this result, however, the Internal Revenue Service ("the Service") urges this Court to use the case before it to create, within the §104(a)(2) tax exclusion, a tortured and untenable distinction between "physical" and "nonphysical" injuries. As to physical injuries, the Service is willing to give §104(a)(2) its clear and obvious meaning of excluding "any damages"; however, as to "nonphysical" injuries, the Service would graft onto §104(a)(2) an additional "burden" on the taxpayer "of establishing that the recovery is reimbursement for a prior loss of personal capital and does not represent a gain or profit that instead adds to her wealth." (Citations omitted). Petitioner's Brief at 14-15.

The Service's attempt to rewrite the Code must be rejected. There is no support in §104(a)(2) for a two-tiered physical/nonphysical injury distinction, in which the victim of a nonphysical injury must shoulder such an additional burden to gain the benefit of the §104(a)(2) exemption. Moreover, there is no basis in §104(a)(2) for a limitation of this exclusion to what the Service terms a "return" of personal "capital." The Service's approach to §104(a)(2) should be rejected by this Court, as it has been by the vast majority of courts of appeals and by the Tax Court.

The Service's distinction also creates an unfair relative tax disadvantage for victims of nonphysical, as opposed to physical, injuries. Such different treatment for victims of nonphysical personal injuries, including discrimination under Title VII, furthers no Congressional purpose, has no basis in tax or civil rights policy and complicates and discourages settlement of discrimination cases – a result directly contrary to Congress' intent in enacting Title VII.

Finally, amici urge this Court to decline the Service's invitation to use this case, in which the Service argues plaintiffs are receiving additional payment for "work already performed," Petitioner's Brief at 18-20, to create a wholesale emasculation of the §104(a)(2) tax exclusion. Amici agree with the court of appeals in this case that plaintiffs were entitled to the benefit of the §104(a)(2) exclusion. However, if this Court should reverse the decision below, amici ask this Court to recognize that many

Title VII victims do not, in any sense, receive pay for work already performed. Amici respectfully submit that any holding in favor of Petitioner in this case should be carefully limited to differential pay situations.

ARGUMENT

I. Title VII Victims Have Suffered Personal Injuries.

If this Court simply applies the language of the §104(a)(2) exclusion to the case before it, rather than accepting the Service's approach, application of §104(a)(2) to Title VII generally, as well as this case, is quite straightforward.

Section 104(a)(2) of the Internal Revenue Code excludes from gross income, with certain specific limitations that are not relevant here,[2] the following:

> the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness.

26 U.S.C. §104(a)(2).

Title VII makes unlawful various forms of discrimination, including:

> to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin.

42 U.S.C. §2000e-2.

The applicable Treasury Regulation provides that, under §104(a)(2):

> The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

26 C.F.R. §1.104-1(c).

[2] These limitations are for amounts attributable to medical expense deductions and for punitive damages. 26 U.S.C. §104(a).

Thus, the question before the Court is simply whether discrimination, such as that outlawed by Title VII, is a "personal injury" that is in the nature of a personal tort. A tort is "a legal wrong committed upon the person or property independent of contract" such as "a direct invasion of some legal right of the individual." BLACK'S LAW DICTIONARY 1335 (5th ed. 1979).

A violation of Title VII is clearly a torttype wrong and illegal discrimination is very much a "personal" injury. The duty not to discriminate arises independently of any contractual relationship the parties may have. Indeed, Title VII expressly extends to situations in which the parties have no contractual relationship, such as where an employer refuses to hire on the basis of race, sex, religion or national origin. 42 U.S.C. §2000e-2.

This Court has recognized, even in reference to 42 U.S.C. §1981, which refers specifically to the right to "make and enforce contracts," that such federal laws, outlawing racial discrimination, create a personal injury claim. This Court has described discrimination as a "fundamental injury to the individual rights of a person." *Goodman v. Lukens Steel Co.*, 482 U.S. 656, 662 (1987). In that case, the Court incorporated the statute of limitations for personal injury claims as the most appropriate statute for §1981 actions. As this Court noted in *Goodman*:

> That §1981 has far-reaching economic consequences does not change the conclusion, since such impact flows from guaranteeing the personal right to engage in economically significant activity free from racially discriminatory interference.

482 U.S. at 661-662.

Title VII is, like §1981, an antidiscrimination statute. Title VII is not, in any sense, a backpay statute. Backpay is one of many potential remedies provided by Congress to promote Title VII enforcement. *See* 42 U.S.C. §2000e-5(g). Title VII does not,

however, regulate the pay an employer provides. *Cf.* 29 U.S.C. §§206 and 207 (fair Labor Standards Act requiring minimum wage and overtime payments). What Title VII prohibits is discrimination, which strikes at the very personhood of its targets, and constitutes a very real and very "personal" injury for its victims.

In short, the amount Title VII plaintiffs receive because they suffer discrimination is undeniably money received "on account of personal injuries." Therefore, §104(a)(2) operates to exclude this recovery from the victim's income.

II. There is No Basis for the Service's Distinction Between "Physical" and "Nonphysical" Injuries Under §104(a)(2) Or Its Requirement that Victims of Nonphysical Injuries Show that Their Recoveries Constitute a "Return of Capital."

In order to avoid a straightforward application of §104(a)(2) to Title VII, the Service asks this Court to adopt and apply the following test to victims of "nonphysical" personal injuries:

> For Section 104(a)(2) to be applicable to a recovery involving a nonphysical injury to personal rights, the taxpayer . . . has the burden of establishing that the recovery is reimbursement for a prior loss of personal capital and does not represent gain or profit that instead adds to her wealth.

Petitioner's Brief at 14-15 (citations omitted).

The Service recognizes, however, as this Court has also acknowledged, that, as to victims of *physical* injuries, lost income recoveries are excluded from income by §104(a)(2). Petitioner's Brief at 21-22, n.16. *See Norfolk & W. Ry. v. Liepelt,* 444 U.S. 490, 496-98 (1980). (Lost future income recovered in a wrongful death case excluded by §104(a)(2).) There is no legal or logical basis for treating victims of *nonphysical* injuries any differently or for imposing upon them the additional burden of showing that their recovery is a "return of capital."

Nothing in the language of §104(a)(2) supports a two-tiered approach for victims of physical and nonphysical personal

injuries. Indeed, the absence of any such distinction in §104(a)(2) is underscored by the fact that, in 1989, Congress amended §104(a) to provide that Section (a)(2) "not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." Pub.L. 101-239, §7641(a), 103 Stat. 2379 (1989)(codified, as amended, at 26 U.S.C. §104(a)). The 1989 amendment, in adding a *specific* distinction relating to punitive damages received for nonphysical personal injuries, makes clear that there is not, and never has been, any *general* distinction between "physical" and "nonphysical" personal injuries under §104(a)(2).

Petitioner argues that exclusions from income "are to be construed narrowly." Petitioner's Brief at 21. Strict construction cannot, however, provide a basis for rewriting tax exemptions. Exemptions to the Internal Revenue Code are "specifically stated and should be construed with restraint in light of the same policy." *Commissioner v. Jacobsen*, 336 U.S. 28, 49 (1949). As with any statute, interpretation "must begin with the statute's language." *Mallard v. U.S. District Court*, 490 U.S. 296, 300 (1989). The plain meaning of such language is generally conclusive. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242 (1989). *See also West Virginia University Hospitals, Inc. v. Casey*, ___ U.S. ___, 111 S.Ct. 1138, 1148 (1991). In *Norfolk & W. Ry. v. Liepelt*, 444 U.S. at 498, this Court viewed the language of §104(a)(2) to be "perfectly clear" in excluding from taxation damages for lost future income recovered in a wrongful death case. Nothing in the statutory language suggests a different rule for lost income caused by race or sex discrimination or other "nonphysical" injuries.

Absent support in the statutory language, the Service attempts to extract support for its "return of capital" theory from the underlying legislative intent. There is no support for this theory in the legislative history. Even if there were, the Service offers no support for its argument that a damage recovery for nonphysical injury must satisfy a return of capital standard in order to be described in §104(a)(2), while a damage recovery for physical injury need not.

To begin with, the Service says (Petitioner's Brief at 10) that the original purpose of the statutory exclusion for personal injury

damages was to "implement" the 1918 decision in *Doyle v. Mitchell Brothers Co.*, 247 U.S. 179 (1918). Yet the committee reports contain no reference to this case, nor do they contain a shred of other evidence to back up the assertion made in the Service's brief. H.R. REP No. 767, 65th Cong., 2d Sess. 9-10 (1918); S. REP. No. 617, 65th Cong., 3rd Sess. 29-30 (1918). The issue in the *Mitchell Brothers* case was whether a lumber company's tax basis in its uncut timber was the timber's original cost, or its value as of the effective date of the tax act in question (the Corporation Tax Act of 1909). There is no reason in the legislative history, or in logic, for this Court to infer any connection whatsoever between *Mitchell Brothers* and the statutory exclusion of personal injury damages.

The 1918 committee reports do not say that, under the preexisting statute, personal injury damages were clearly taxed, or clearly not taxed (in which case there would have been no reason for the enactment). The reports say, without explanation, that taxation under the existing statute was "doubtful," and that under the new statute such damages "shall not be included in income." H.R. REP. No. 767 at 9-10, S. REP. No. 617 at 29-30. There is no reference to the return of capital theory or any other tax policy.

The absence of any reference to the return of capital theory is not surprising. This theory offers no persuasive reason why replacement of past or future earnings should be excluded from income, whether the injury be physical or nonphysical. If the capacity to labor is a capital asset that is merely exchanged or converted to money, producing no net gain, then wages actually earned would not be "income" either.

The return of capital theory also does not explain how the amount of "capital" invested in the human person should be measured in order to determine the tax consequences of such items as damages for pain or impairment. If an accident victim loses the use of an eye, why should one assume in every case that there is invested capital (or tax "basis") in the use of the eye, and that the amount of basis is at least as much as the damages recovered? Apparently, the "return of capital" theory also assumes infinite basis, so that there can never be any taxable gain when the eye, or some other human capacity, is converted

to money damages. Surely if a taxpayer *sold* his eye for medical or other use, the Service would not acknowledge any capital or basis in the eye, and would tax the full proceeds as income.

As many commentators have noted, the "return of capital" theory simply does not provide the basis for the exclusion of §104(a)(2), and there is no persuasive evidence that Congress would have thought so, or did in fact think so. The full Tax Court, sitting *en banc* earlier this year, put it well:

> We doubt whether the return of capital theory justifies the exclusion from income of the full range of damages found to be excludable under section 104(a)(2), particularly damages received in lieu of lost income. Perhaps, even originally, a more satisfactory justification for excluding a recovery for lost earnings as well as a recovery for pain and suffering may have been based on emotional and traditional, rather than logical, factors. Whatever reasons initially motivated Congress to enact an exclusion for damages received on account of personal injuries or sickness, a contemporary inquiry must by necessity restrict itself to the language of section 104(a)(2), and administrative and judicial interpretations of that language.

Downey v. Commissioner, 97 T.C. 150, 159 (1991)(citation to scholarly articles omitted).

The Service asks the Court to infer not only that Congress intended to adopt the return of capital theory but also that its intent was even more specific — *i.e.*, that §104(a)(2) silently intends to impose the return of capital theory, whatever that means, on recoveries for nonphysical personal injuries but not physical personal injuries. There is no evidence of any such intent, and the Court should not infer it.

Absent support in the statutory language or legislative intent, the Service resorts to its own history of interpreting §104(a)(2) and its predecessors. The Service advises the Court that, in 1920, the Service conjectured that the 1918 statute was "[p]robably . . . merely declarative" of the human capital theory. Solicitor's Memorandum 1384, 2 C.B. 71, 72; *revoked* by Solicitor's Opinion 132, I-1 C.B. 92, 94 (1922).

After 1922, the Service says that its position was based on two beliefs that have since been shown to be wrong. First, the Service says it believed the statutory exclusion for personal injury damages embodied a general distinction between physical and nonphysical injuries. Petitioner's Brief at 11-12. As discussed *supra* at 7, the 1989 amendment of §104(a)(2) would make no sense if this general distinction existed. Moreover, even the Service now grudgingly acknowledges that recoveries for both physical and nonphysical personal injuries must be analyzed under the specific §104(a)(2) exclusion. Petitioner's Brief at 14, n.13.

Second, the Service says it believed a separate statutory exclusion for nonphysical injuries was in large part unnecessary, because the return of capital theory would make a tax on such damages unconstitutional in any event. Petitioner's Brief at 12-13. However, the notion of a constitutional restriction that would limit the kinds of income Congress can tax has also proven wrong. *See Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955), discussed *infra*.

The Service in effect cites its own long record of erroneous interpretation on this issue as a reason why this Court should now rescue the Service from the clear language of §104(a)(2) and the weight of lower court authority. The Service's own long record of error is no reason for the Court to adopt the Service's strained and unsupported interpretation of §104(a)(2).

Nor can the Service derive any support for its two-tiered additional burden approach from the case law. *Commissioner v. Glenshaw Glass Co., supra*, apparently forms the basis for much of the Service's argument. *See* Petitioner's Brief at 7, 9, 13, 15, 18 & 21. That case, however, offers absolutely no support for the Service's position. *Glenshaw Glass* held that the punitive portion of treble damages received by a corporation was "income" under the predecessor of §61 of the Internal Revenue Code. Some taxpayers, based on *dictum* in *Eisner v. Macomber*, 252 U.S. 189, 207 (1920), had argued that the general concept of "income" under the Code was limited to returns derived from the taxpayer's labor or capital. This notion was rejected. The only statutory *exclusion* from gross income that was considered in *Glenshaw Glass* was the exclusion for gifts. 348 U.S. at 432. The Court

had no reason even to consider "any other exemption under the Code." *Id.* The case involved no personal injury, and the Court neither rejected nor adopted any position of the Service regarding compensation for personal injuries. 348 U.S. at 432, n.8.

The Service's further reliance (Petitioner's Brief at 14) on *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962), in support of its two-tiered additional burden approach to nonphysical injuries under §104(a)(2), ignores the very real injury caused to victims of nonphysical injuries, such as discrimination. *Starrels* held that a payment to a taxpayer in return for an *agreement* to allow a motion picture to be made regarding her family was not excluded by §104(a)(2). The court rejected the taxpayer's argument that §104(a)(2) excluded from taxation payments made in return for the taxpayer selling her privacy rights. That case makes perfect sense but it has no application here. Title VII plaintiffs do not, in any sense, voluntarily agree to be victims of discrimination, nor do they sell their rights to be free of discrimination, in return for an award of backpay. They have been victims of an "actual invasion of personal rights," 304 F.2d at 576, and thus, as the *Starrels* court itself would have recognized, are entitled to the §104(a)(2) exclusion.

Social Security Board v. Nierotko, 327 U.S. 358 (1946), relied on by Petitioner at 19, 26 and 28, is also of no help. That case contains no consideration of the exclusion in §104(a)(2). Instead, the Court considered whether a backpay award to an employee under the National Labor Relations Act came within the definition of "wages" under the Social Security Act. It appears that counsel, and therefore the courts, simply assumed that the backpay in issue was "income," and focused only on whether the backpay was also included in the narrower subcategory, "wages." Neither this Court nor the court of appeals ever considered that the exclusions from the definition of "income" under the Internal Revenue Code — such as the one in §104(a)(2) — might also apply under the Social Security Act. *See also Nierotko v. Social Security Board*, 149 F.2d 273 (6th Cir. 1945),

aff'd, 327 U.S. 358 (1946).[3]

Nor can the Service garner current support for its two-tiered additional burden analysis from the lower courts. The appellate courts and the Tax Court, many of which once accepted the Service's approach, have now overwhelmingly rejected it. Those courts have overwhelmingly rejected any distinction between physical and nonphysical injuries or any additional inquiry into the nature of the recovery in a nonphysical injury case. Instead, those courts have concluded that, in reference to both physical and nonphysical personal injuries:

> [W]hether the damages received are paid on account of 'personal injuries' should be the beginning and end of the inquiry. To determine whether the injury complained of is personal, we must look to the origin and character of the claim and not to the consequences that result from the injury.

Threlkeld v. Commissioner, 87 T.C. 1294, 1299 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988). *Accord Downey v. Commissioner*, 97 T.C. 150 (1991)(age discrimination); *Metzger v. Commissioner*, 88 T.C. 834 (1987), *aff'd without published opinion*, 845 F.2d 1013 (3d Cir. 1988)(discrimination based on sex and national

[3] Subsequently, however, the courts have recognized, and the Service apparently agrees (*see* Petitioner's Brief at 10, n.5) that the §104(a)(2) exclusion also applies to Social Security taxes. As the courts have come to realize, "wages" is a subset of "income" for tax purposes. *Rowan Companies, Inc. v. United States*, 452 U.S. 247, 254 (1981); *Royster Co. v. United States*, 479 F.2d 387, 390 (4th Cir. 1973). If an item is excluded from "income" under §104(a)(2), then it is not taxable as "wages." *Anderson v. United States*, 929 F.2d 648, 654 (Fed. Cir. 1991); *Redfield v. Insurance Company of North America*, 940 F.2d 542, 548 (9th Cir. 1991).

origin);[4] *Rickel v. Commissioner*, 900 F.2d 655, 659 (3d Cir. 1990), *aff'g in part and reversing in part*, 92 T.C. 510 (1989)(age); *Pistillo v. Commissioner*, 912 F.2d 145, 148 (6th Cir. 1990), *rev'g* T.C. Memo 1989-329 (1989)(age); *Redfield v. Insurance Company of North America*, 940 F.2d 542, 545 (9th Cir. 1991)(age); *Wulf v. City of Wichita*, 883 F.2d 842, 872 & n.39 (10th Cir. 1989). *But cf. Thompson v. Commissioner*, 866 F.2d 709, 712 (4th Cir. 1989)

[4] The Service cites (Petitioner's Brief at 25 & n.19) certain Tax Court decisions, including *Hodge v. Commissioner*, 64 T.C. 616 (1975), as supporting its position in this case. In fact, however, *Threlkeld* overruled the analysis used in *Hodge*. In *Metzger*, the Tax Court specifically ruled, following *Threlkeld*, that a violation of Title VII was a personal injury unde §104(a)(2). Subsequently, some Tax Court decisions deviated from the *Threlkeld* approach. *See Rickel*, 900 F.2d at 659, n.5 (analyzing the Tax Court's sometimes inconsistent approaches). However, the Tax Court's most recent opinion in *Downey* represented a reconsideration, *en banc*, of the Tax Court's approach. *Downey* reaffirms *Threlkeld* and overrules, either expressly or by implication, any of the Tax Court's decisions that looked to the consequences, rather than the nature, of a nonphysical personal injury.

(discussed *infra* at 21).[5]

In sum, as the majority of appellate courts and the Tax Court have come to recognize, the Service's distinction between physical and nonphysical injuries, and imposition of an additional burden on victims of nonphysical injuries, has no basis under §104(a)(2). Amici ask this Court to reject once and for all the Service's tortured and unfounded approach to this exclusion.

III. The Service's Interpretation of §104(a)(2) Unfairly Discriminates Against Victims of Nonphysical Personal Injuries.

Of particular concern to amici is the fact that the Service's strained interpretation of §104(a)(2) discriminates against victims of nonphysical personal injuries — such as plaintiffs who have been victims of race and sex discrimination. The Service's interpretation of §104(a)(2) adds a new wrinkle to this already complex area of litigation and operates to discourage and

[5] The Court of Appeals for the D.C. Circuit recently ruled, using a different analysis, that Title VII plaintiffs should be deprived of the §104(a)(2) exclusion. *Sparrow v. Commissioner*, No. 90-1151 (D.C.Cir. Nov. 26, 1991). The court erroneously focused on Title VII's backpay remedy and concluded that Title VII backpay could not be considered "damages" under §104(a)(2) because it was a remedy "in equity" and not damages "at law." This eccentric analysis would result in taxation of backpay only in cases brought under Title VII and not other statutes, thereby producing inconsistent results for victims of discrimination suing under different statutes, or even for a single victim of discrimination asserting a claim under more than one statute. Moreover, the D.C. Circuit's analysis ignores the Treasury Regulations, which define a "personal injury" by reference to the type of *right* violated ("tort or torttype right"), not the type of remedy. The Regulations also contradict *Sparrow*'s hypertechnical approach to the meaning of the term damages, stating only that damages "means an amount received." 26 C.F.R. §1.104-1(c). Finally, the D.C. Circuit's law-equity distinction ignores the fact that, at the time that §104(a)(2) was incorporated into the Internal Revenue Code of 1954, the distinction between actions at law and suits in equity in federal courts had long since been abolished by the 1938 Federal Rules of Civil Procedure. *See* Fed.R.Civ.P. 1 and 2 and Advisory Committee Notes.

complicate settlement of these cases. There is no basis in either tax policy or the civil rights laws for a two-tiered additional burden approach to victims of nonphysical personal injuries.

To the extent that §104(a)(2) excludes income which otherwise would be or should be subject to taxation, the Service's policy arguments must be addressed to Congress, which could act to narrow the §104(a)(2) exemption. The policy argument on the other side is, of course, that "the injured party, who has suffered enough, should not be further burdened with the practical difficulty of sorting out the taxable and nontaxable components of a lump-sum award." *Roemer v. Commissioner*, 716 F.2d 693, 696 (9th Cir. 1983). There is no basis, however, either in policy or in the current statutory language, for the Service's two-tiered additional burden approach. Victims of Title VII and other nonphysical injuries are not seeking special tax treatment, but simply treatment in accordance with that afforded other victims of personal injuries.

The Service argues that Title VII payments are based on compensation that plaintiffs otherwise would have received and that such compensation would have been taxable income. Petitioner's Brief at 19. This is equally true, however, in numerous recoveries in physical injury cases in which part, or even all, of a plaintiff's recovery is his lost past or future earnings. See, *e.g., Norfolk & W. Ry. v. Liepelt, supra*, 444 U.S. at 496. A victim who cannot work because he is black is no less barred from employment than a victim who cannot work because he is physically injured.

The Service also argues that its tax treatment is appropriate because, under Title VII, the only monetary relief available is backpay. Petitioner's Brief at 17. Thus, the Service apparently seeks to suggest that no "sorting out" of taxable and nontaxable amounts would be necessary in Title VII cases. The Service's facile approach, however, cannot mask the practical "sorting" problems that are inherent in the two-tiered additional burden approach.

In suits for injuries ranging from slander to defamation to age discrimination to race discrimination under 42 U.S.C. §1981, the Service's approach would require that both state and federal

courts apportion damages into various taxable and nontaxable components. Instead of simply excluding "any damages," as §104(a)(2) now provides, the Service would exclude only those damages that represent what the Service calls a "return of capital." At the very least, such an approach would necessitate special interrogatories and jury instructions to guide the apportionment of recoveries into taxable and nontaxable items.

Moreover, Title VII awards, too, would require sorting out. Under the Civil Rights Act of 1991, Title VII has been amended to provide for compensatory, as well as punitive, damages, including "emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses." Pub.L. §102-166, 102(a)(1) and (b)(3)(to be codified at 42 U.S.C. §1981A). Even under the Service's additional burden approach, these kinds of compensatory damages would presumably be excluded under §104(a)(2), since they compensate for what the Service views as a prior loss of personal capital. *See* Petitioner's Brief at 12. Thus, apportionment, special interrogatories, and a maze of varying tax consequences will also be a part of litigation under Title VII.

Of even greater practical concern to amici, however, than the impact on litigation, is the impact of the Service's two-tiered additional burden approach on the potential for settlement of discrimination suits. By distinguishing between physical and nonphysical injuries and then placing an additional burden on taxpayers who have recovered for nonphysical injuries, the Service's approach adds both expense and complication to any potential settlement for such injuries. This result is particularly inappropriate under Title VII, in light of Congress' express policy of favoring voluntary compliance and settlement of such suits. *See Alexander v. Gardner-Denver Co.*, 415 U.S. 36, 44 (1974); *Ford Motor Co. v. EEOC*, 458 U.S. 219, 228 (1982).

The position of the Service has made settlement of Title VII and other discrimination cases needlessly difficult and costly. When a chance exists that all or a portion of a settlement will be viewed by the Service as taxable income and "wages," a conservative defendant will take the position that income taxes and employment taxes must be withheld as a condition

of the settlement.[6] Defendants also point out that their true cost to settle includes the settlement amount *plus* those components of employment taxes that are not withheld from wages but are imposed directly on the employer as an excise tax.[7] These and many other tax issues can become huge factors in the settlement process, driving up the cost of settlement and forcing the plaintiff class to hire expensive tax professionals just to negotiate and administer the tax aspect of settlement of the case.

Complex allocation issues based on taxes will continue to plague the settlement process if this Court sustains the Service's position in this case. For example, it can be argued that Title VII recoveries represent not only "backpay" but also pre-judgment interest accrued since the time the discriminatory conduct occurred. While the Service says that backpay is subject to both income taxes and FICA/FUTA taxes, interest is clearly *not* subject to FICA/FUTA taxes, nor is it subject to income tax withholding by the defendant.[8] Thus, under the Service's current position, there are strong tax incentives to treat part of the settlement as pre-judgment interest in order to save the cost of FICA and FUTA taxes. Defendants worry, however, that the Service, on audit, may not respect the allocation to interest and may treat those dollars as if they were additional "wages," resulting in personal liability against the defendant for FICA/FUTA taxes, for income taxes not withheld, and for

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[6] The Federal Insurance Contribution Act (FICA) imposes Social Security and Medicare taxes on "wages." *See* 26 U.S.C. §3101 (tax imposed on individuals' income if such income constitutes "wages"); 26 U.S.C. § 3102 (collection of the employee's tax through withholding by the employer). Employers also must deduct and withhold the employee's income tax from "wages." 26 U.S.C. § 3402.

[7] *See* 26 U.S.C. §3111 (half of FICA tax imposed directly on the employer); 26 U.S.C. § 3301, *et seq.* (unemployment insurance tax imposed on employers by the Federal Unemployment Tax Act).

[8] *See e.g.*, Revenue Ruling 80-364, 1980-2 C.B. 294 (back pay is "wages," interest is not).

substantial penalties.[9] Negotiation of these matters is therefore a difficult and costly struggle for the parties. Moreover, the recent amendment of Title VII, discussed *supra* at 16, which expands the relief available under Title VII, will further complicate settlements, if the parties are required to engage in complex damage allocations acceptable to the Service.

To cite just one example of the tax-based complexity that plagues Title VII cases, about one-third of the lengthy settlement agreement in a recently settled class action, plus a five-page "side letter," deals solely or largely with tax matters.[10] The parties wrestled with such issues as (1) backpay vs. interest; (2) conditions under which the defendant would be willing to rely on the interest allocation and forego withholding and employment taxes; (3) the process for seeking a binding determination from the Service or an opinion of outside tax counsel prior to the distribution of money to the class members; (4) allocation of attorneys' fees and costs as between backpay and interest; (5) how a windfall to the defendant would be avoided where the employer's share of employment taxes was paid out of the settlement shares of the thousands of class members who were also current employees of the defendant; and (6) many other tax-related issues. Tax issues consumed countless hours of the parties' time and $80,000 was spent on tax counsel fees by the plaintiffs alone.

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[9] An employer who pays "wages" and does withhold income taxes or the employee's half of FICA taxes is personally liable for the amounts that should have been withheld but were not. *See* 26 U.S.C. §§3102(b) (FICA), 3403 (income tax withholding). The employer is also liable for (1) FUTA tax, (2) the employer half of FICA tax, and (3) a 10 percent penalty for failure to make a timely deposit of all required FICA/FUTA taxes and required income tax withholding. 26 U.S.C. §6656.

[10] *EEOC, et al. v. AT&T Technologies, Inc.*, No. 78 C 3951 and No. 82 C 1542 (N.D.Ill.) is a federal sex discrimination class action on behalf of approximately 13,000 women, alleging that the defendant carried out discriminatory policies against women taking maternity leaves from employment. The parties' settlement negotiations related to taxation issues began in earnest in February of 1991 and were not completed until July. The settlement was approved by the court on December 9, 1991.

In short, the Service's position, if adopted by the Court, would perpetuate drawn out and costly disputes in which plaintiffs attempt to characterize amounts of money as being one thing, in order to save the cost of taxes for both parties, and defendants, fearing tax liability, insist on the conservative position that all or much of the settlement consists of taxable "back wages," from which the Service is entitled to take its cut. Settlements are more expensive and tax issues may operate to discourage the parties from settlement, resulting in more protracted litigation. These costly and complex impediments to settlement would be eliminated if this Court simply gives §104(a)(2) its plain and intended meaning. Discrimination cases could then be settled just like any other personal injury case, without costly disputes over tax issues.[11] Discrimination victims would receive the same tax treatment as other tort victims.

IV. The Possibility that Plaintiffs' Recovery Here Was for "Work Performed" Provides No Basis for the Service's Position in this Case.

The Service repeatedly emphasizes that plaintiffs' recovery in this case was "for work already performed." Petitioner's Brief at 18-20, 21. The Service likens this to a suit for wage deficiencies or a wage differential. *Id.* at 5 (citing Opinion of the District Court, Pet. App. 32a). This characterization, however, even if it accurately describes the remedy provided in the case

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[11] If backpay for discrimination is not taxable, then the only arguably taxable items that could be recovered in such cases would be interest and, after 1991, punitive damages. Simplicity is best achieved, however, by holding that *all* amounts received (except punitive damages) are not taxable. Alternatively, the parties could treat a settlement as an amount of damages *without* interest. *See McShane v. Commissioner*, T.C. Memo 1987-151, 53 T.C.M. 409 (1987). However, this may require sophisticated consideration by the parties of the tax issues. Punitive damages are not an issue because they are simply not agreed to by defendants as part of settlements, even in cases where they could be awarded at trial.

before the Court,[12] cannot support the Service's general approach to Title VII and other nonphysical injury recoveries.

First, amici note that there is little basis for characterizing invidious wage discrimination as anything other than a personal injury. An employee who is paid less because she is female or black has been discriminated against and the wrong committed is to her person. *See* 42 U.S.C. §2000e-2(a). Compare 29 U.S.C. §206 (minimum wage requirements). In addition, a wage differential often forms one component of a physical injury case, where, for example, a physical injury requires a plaintiff to obtain a lower paying job because he can no longer perform a job he held prior to his injury. Presumably the Service would agree that this recovery would be excluded by §104(a)(2). Thus, neither the injury involved nor the remedy provided offers any basis for depriving plaintiffs here of the §104(a)(2) exclusion.

Moreover, to describe any backpay in a discrimination case as compensation "for services" is simply to mischaracterize the nature of the Title VII remedy. The backpay is not a liability that the employer incurred in order to obtain services. The reason for the payment of compensation is the employer's illegal discrimination, not the work the plaintiff performed.

More importantly, even if backpay could be viewed in some sense, in some cases, as "compensation for services" under Code §61(a)(1), this does not address the §104(a)(2) analysis. Items included in the general concept of income, or even specifically listed in §§61(a)(1) through (15), are included in "gross income" only "[e]xcept as otherwise provided in this subtitle," *e.g.*, except as otherwise provided in §104(a)(2).[13] The fact that damages

[12] Amici's understanding is that the settlement proceeds were not awarded or distributed on a backpay basis, nor was any attempt made to provide an appropriate differential to each plaintiff to provide her with a nondiscriminatory rate of pay. The specific nature of the award in this case, however, is most properly addressed by the parties.

[13] Other kinds of "compensation for services" are also excluded by "other provisions" of subtitle A, such as health insurance (§106). Similarly, other items specifically listed in §61(a) are, nevertheless, in some circumstances, excluded under another provision of subtitle A. *E.g.*, discharge of indebtedness income under §§61(a)(12) and 108.

received may also be viewed as "compensation for services," provides absolutely no support for the government's position.

However, even if a distinction is to be drawn in wage differential cases under §104(a)(2), the Service's proposed interpretation of that Section must still be rejected. After repeatedly stressing the fact that plaintiffs' recovery here was for work already performed, the Service argues that there is no distinction between salary discrimination cases and cases involving discriminatory firing or failure to hire. Petitioner's Brief at 26, n.20. The Service seeks a wholesale limitation on, and two-tiered additional burden approach to, all nonphysical injuries under §104(a)(2) and that approach must be rejected.

One court of appeals has drawn a distinction, under §104(a)(2), for a salary discrimination case, but on very narrow grounds. In *Thompson v. Commissioner*, 866 F.2d 709 (4th Cir. 1989), the Fourth Circuit held that a wage differential award under the Equal Pay Act of 1963, 29 U.S.C. §206(d), and under Title VII did not fall within the §104(a)(2) exclusion. The court reasoned that plaintiff "received compensation for services rendered whereas a tort plaintiff receives compensation for the inability to earn an income due to the tortious action of a defendant." 866 F.2d at 712. Amici respectfully disagree with the decision in *Thompson* for the reasons stated *supra* at 20-21. As other courts have recognized, however, even under the court's analysis in *Thompson*, recovery of backpay by a terminated employee or an employee who was not hired would still be excluded by §104(a)(2). *Redfield, supra*, 940 F.2d at 546; *Rickel, supra*, 900 F.2d at 664, n.16.

The government's disingenuous description of the recovery in this case — pay for "work performed" — should not be permitted to color this Court's analysis of the general nature of the "personal injury" of illegal discrimination. Cases involving illegal pay differences for "work performed" are a small fraction of the cases to which the Court's opinion in this case may be applied. Persons who are discharged, not hired, or not promoted to higher positions represent the bulk of discrimination victims. In the physical injury case there is no doubt that damages representing wages that should have been earned, but were not because of the injury, are excludable from tax. Victims of illegal discrimination are

in precisely the same position and are entitled to the same treatment.

By selecting this case as its vehicle for Supreme Court review, and by its description of the recovery as pay for work performed, the Service attempts to color the Court's analysis and, if the Court reverses, perhaps also to obtain a rationale for denying the benefits of §104(a)(2) to the more typical discrimination claimants who cannot be said, in any sense whatsoever, to be receiving pay for work performed. Amici respectfully request this Court to decline the Service's invitation to use this case as a vehicle for such an emasculation of the §104(a)(2) exclusion.

CONCLUSION

The judgment of the court of appeals should be affirmed.

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